

No. 9832

IN THE
United States Circuit Court of Appeals
For the Ninth Circuit

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

vs.

BISHOP TRUST COMPANY, LIMITED, Executor
of the Estate of John A. McCandless,
Deceased,
Respondent.

On Petition to Review a Decision of the United States
Board of Tax Appeals.

BRIEF FOR RESPONDENT.

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FILED

MAR - 5 1942

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General Council Memorandum

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BRIEF FOR RESPONDENT.

OPINION BELOW.

The opinion of the Board of Tax Appeals (R. 18-30) was filed on November 27, 1940, and is reported in 42 B. T. A. 1309.

JURISDICTION.

The decision of the Board of Tax Appeals (R. 29-30) was entered on January 28, 1941, and the petition for review (R. 30-37) was filed on April 19, 1941. The jurisdiction of this Court is invoked under Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED.

Whether the income of a decedent's estate received by the estate during the period of administration or settlement of the estate and within the taxable year and paid over to the testamentary trustee as a part of the residue of the decedent's estate was deductible as income properly paid or credited to a legatee, heir or beneficiary within the meaning of Section 162(c) of the Revenue Act of 1934?

STATUTE INVOLVED.

Revenue Act of 1934, c. 277, 48 Stat. 680:

"Sec. 162. Net Income.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

* * * * *

(c) In the case of income received by estates of deceased persons during the period of administration or settlement of the estate, and in the case of income which, in the discretion of the fiduciary, may be either distributed to the beneficiary or accumulated, there shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year, which is properly paid or credited during such year to any legatee, heir, or beneficiary, but the amount so allowed as a deduction shall be included in computing the net income of the legatee, heir, or beneficiary. (U. S. C., Title 26, Sec. 162.)"

STATEMENT OF FACTS.

Respondent on review, Bishop Trust Company, Limited, a Hawaiian corporation, was during the taxable year 1936 the duly appointed and acting executor under the will and of the estate of John A. McCandless, who died a resident of Honolulu on January 30, 1930. He left a large estate and in his will named Bishop Trust Company, Limited, as his executor and also as the testamentary trustee of his residuary estate and it duly qualified as such. The will provided that the executor pay to the decedent's widow \$1000 per month for support and maintenance during the administration of his estate, the first of such payments to be made one month from the date of his death and succeeding payments in like amount on the same day of each succeeding month until such time as his residuary estate should be turned over to the testamentary trustee. He also directed that the executor should pay to each of his four grandchildren for support, maintenance and education during the administration of the estate \$250 per month, the first payment to be made one month from the date of his death and succeeding payments on the same day of each succeeding month until such time as his residuary estate should be turned over to the testamentary trustee (R. 20).

The provision in the will establishing the trust of the residuary estate was as follows:

“Eighth. I give, devise and bequeath all of the rest, residue and remainder of my estate, real, personal or mixed, wheresoever situated and of every kind or nature, and any property over

which I shall possess any power of appointment, to Bishop Trust Company, Limited, an Hawaiian corporation, in trust for the uses and purposes and with the powers as hereinafter stated, * * *"
(R. 21)

The trustee was directed "to pay and deliver from the accumulations and net income of my said trust estate" \$1000 per month to the widow beginning one month from the date of the last monthly payment made to the widow by the executor and continuing until such time as his eldest grandchild should attain the age of twenty-one years, after which the widow was to receive one-tenth of the annual net income of the trust. The trustee was also directed "to pay and deliver from the accumulations and net income of my said trust estate" \$250 per month to each grandchild. After a grandchild attained the age of twenty-one years he or she was to receive one-tenth of the annual net income of the trust estate. Surplus income of the trust estate was to be accumulated and invested. When the youngest grandchild attained the age of thirty years the trust was to determine and one-fifth of the trust estate was to be paid to the widow, if living, and one-fifth to each grandchild per stirpes (R. 21).

On January 12, 1936, the respondent on review filed a petition in the Circuit Court of the First Judicial Circuit, Territory of Hawaii, sitting in probate, requesting approval of its first and final account of the administration of the estate, and that "an order be made to deliver all such property as remains to the persons entitled thereto, and that petitioner be re-

lieved from all further responsibilities as executor under the will and of the estate of John A. McCandless" (R. 22).

On January 21, 1936, the Probate Court entered an order that Bishop Trust Company, Limited, should convey, transfer and deliver the "assets remaining in its hands as executor" to itself as trustee (R. 22). Pursuant to said order, Bishop Trust Company, Limited, as executor, transferred and delivered to itself as trustee the residue of the decedent's estate and was discharged as executor of the estate, subject to the performance of specific acts which have since been performed (R. 23).

The respondent on review kept its accounts and made its income tax returns on both Form 1040 and Form 1041 on a cash receipts and disbursements basis and on the basis of a fiscal year beginning February 1st and ending January 31st. The returns were filed with the Collector at Honolulu (R. 23).

Included in the residuary estate of the decedent, which respondent on review, as executor, transferred to itself as trustee, pursuant to the order of the Court, was \$20,504.58 cash, which had been received by the respondent on review, as executor, as income during the taxable year ended January 31, 1936. This amount was claimed as a deduction in the return which the respondent on review, as executor, filed on behalf of the estate for the fiscal year ended January 31, 1936. Bishop Trust Company, Limited, as testamentary trustee, in the return, filed on behalf of the trust for

the same fiscal year, included in the gross income of the trust \$19,639.72 of the said amount and duly paid income tax thereon (R. 24).

In the determination of the deficiency herein involved, the Commissioner disallowed this deduction on the ground that it was not allowable under the provisions of Section 162(c) of the Revenue Act of 1934 (R. 24).

The question of the deductibility of the amount of \$20,504.58 from the income of the estate is the only issue in this case before the Court.

SUMMARY OF ARGUMENT.

Section 162(c) of the Revenue Act of 1934 requires the following conditions to be present in order that an estate be allowed a deduction thereunder:

1. There must be involved income received by the estate of a decedent during the period of administration or settlement of the estate;

2. Such income must be properly paid or credited during such year; and

3. Such income must be paid or credited to a legatee, heir or beneficiary.

The Commissioner does not deny that all of the statutory conditions were fully met in the present case, but he seeks to add to the statutory requirements a new element, namely, that the income of the estate properly paid or credited to a legatee, heir or beneficiary during the taxable year is still not deductible

unless it was paid out as income, and then he erroneously contends that the amount paid out was not paid as income. The Board found against the Commissioner on both these contentions, and it is this finding that presents a very narrow issue in this case. Furthermore, this is a case where the trustee has already paid the tax on the amount here in question and the Commissioner, by raising a new and as we contend unfounded technical issue, seeks to assess the tax for a second time on the same amount against the executor.

Respondent on review contends:

1. That it is not necessary that the payment of the income of an estate in administration be made to a legatee, heir or beneficiary as income in order that such income paid may be deducted by the estate in computing its net income.

2. That even if it were necessary that income of an estate in administration be paid to a legatee, heir or beneficiary as income in order to be deductible by the estate in computing its net income, the income here in question was so paid out to the beneficiary as income.

(A) Under the laws of the Territory of Hawaii the income in question retained its character as income upon distribution by the executor of the estate.

(B) Under the provisions of the will the income of the estate retained its character as income when distributed to the testamentary trustee.

ARGUMENT.

1. THAT IT IS NOT NECESSARY THAT THE PAYMENT OF THE INCOME OF AN ESTATE IN ADMINISTRATION BE MADE TO A LEGATEE, HEIR OR BENEFICIARY AS INCOME IN ORDER THAT SUCH INCOME PAID MAY BE DEDUCTED BY THE ESTATE IN COMPUTING ITS NET INCOME.

The Commissioner of Internal Revenue has admitted in his answer to the petition of the respondent on review (Par. V(M)), (R. 17), that "included in the residuary estate of the taxpayer which was conveyed, transferred and delivered, on January 22, 1936, to Bishop Trust Company, Limited, trustee, under the will and of the estate of John A. McCandless, deceased, pursuant to an order of Court made January 21, 1936, was \$20,504.58 cash income received by the taxpayer during the taxable year ended January 31, 1936, as alleged in subparagraph M of paragraph V of the petition".

The Commissioner does not dispute that this amount which was admittedly income of the estate during administration was properly paid or credited during such year. The Commissioner appears to recognize the well settled rule of law that the law of the state having jurisdiction of the estate and the trust is determinative of whether the distribution is proper or not.

In *G.C.M.* 4596, VII-2, *C.B.* 133, the question was whether where the will merely provided for the distribution of bequests and for the disposition of the residuary estate, and was silent as to the distribution of income during administration, the amount paid or credited to the residuary legatee in respect to current

income may be recognized under Section 219(b)(3) of the Revenue Act of 1926. (This section is identical with Section 162(c) of the Revenue Act of 1934.) The answer given in said *G.C.M.* was that the law of the particular state involved must be considered in determining whether the income may be properly paid or credited to the residuary legatee and any income properly paid or credited is deductible, and unless the will or the applicable state law makes the payment or credit improper, it is deductible under said section. *I.T.* 2349, VI-1, *C.B.* 78, and *Tyler*, 9 B.T.A. 255, are cited in support thereof.

In *Proctor v. White*, 28 Fed. Supp. 161 (D.C. Mass.), it was said that the words "properly paid" in the Revenue Acts means rightly paid with legal justification, and since the testatrix was a resident of Massachusetts and the disposal of her property in the estate was subject to the orders of its Courts respecting distributions of estates, the laws of that state, with jurisdiction of the administration, determine what income of the trust is properly to be paid to the beneficiaries.

In *County National Bank and Trust Company, Executor*, 39 B.T.A. 357, it was said that the provisions of the will and the laws of the state having jurisdiction over the administration determine what income of a trust estate was properly paid to the beneficiary, and there was cited in support thereof *Anderson v. Wilson*, 289 U.S. 20, and *Merchants Loan and Trust Company v. Smietanka*, 255 U.S. 509.

In *Sewell v. U.S.*, 19 Fed. Supp. 657 (Ct. Cl.), it was said that there can be no question but that the law of the state, as promulgated by the Courts of the state in which the will is probated, governs in the interpretation of the trust as respects the taxability of the income as between the trust and the beneficiary.

The Commissioner apparently also concedes that Bishop Trust Company, Limited, trustee as aforesaid, was a legatee, heir or beneficiary within the meaning of Section 162(c). Under the provisions of the will of John A. McCandless, deceased, all the rest, residue and remainder of the estate, real, personal or mixed, was given to Bishop Trust Company, Limited, in trust for the uses and purposes therein stated. It is well settled that a trust created under a will may be a legatee, heir or beneficiary within the provisions of Section 162(c) of the Revenue Act of 1934. *Estate of Ida A. White, Deceased*, 41 B.T.A. 525. (Commissioner's Appeal dismissed October 16, 1940, C.C.A. 6.)

In *I.T.* 1621, II-1, *C.B.* 129, with regard to Section 219(c) of the Revenue Act of 1921, which is identical with Section 162(c) of the Revenue Act of 1934, so far as the determination of the net income of estates in administration is concerned, it was said:

“Amounts of income paid in final distribution if they are so paid in accordance with the law of the State and the terms of the will, if there is one, are properly paid or credited within the meaning of Section 219(c) and are, therefore, deductible in the return for the estate.”

The Commissioner, however, in spite of all the rulings and decisions and in spite of the very plain wording of the Revenue Act in question, would add a further element to the requirements of Section 162(c), namely, that in addition to income of the estate being properly paid or credited in the taxable year to a legatee, heir or beneficiary, it must retain its character as such upon the distribution. All the statute requires is that the amount in question be income of the estate during the taxable year, and the Commissioner has admitted that that is the case in the present instance. It is, therefore, respectfully submitted that it is not necessary to go any further into the question, but the issue can be determined upon the finding that inasmuch as the Commissioner has admitted that the amount in question distributed to the residuary trustee was income of the estate during the taxable year, distributed to a beneficiary during the taxable year in accordance with proper legal authority, that that is all the statute requires in order for the estate to be allowed the deduction claimed.

2. THAT EVEN IF IT WERE NECESSARY THAT INCOME OF AN ESTATE IN ADMINISTRATION BE PAID TO A LEGATEE, HEIR OR BENEFICIARY AS INCOME IN ORDER TO BE DEDUCTIBLE BY THE ESTATE IN COMPUTING ITS NET INCOME, THE INCOME HERE IN QUESTION WAS SO PAID OUT TO THE BENEFICIARY AS INCOME.

(A) Under the laws of the Territory of Hawaii the income in question retained its character as income upon distribution by the executor of the estate.

The law of the Territory of Hawaii with respect to the issue now before this Court is to the effect that when a testator gives the residue of his estate to trustees who are charged with the duty of paying the income thereof to certain named persons, they are entitled to the income of the clear residue as afterwards ascertained from the date of the death of the testator, and the fact that the executors are entitled to and do retain the residuary estate in their hands until the close of administration can make no difference in the status of income accruing thereon pending administration. If, therefore, the payment or delivery of the residuary estate to the trustees by the executors is postponed until the close of administration and the executors have in the meantime collected the income earned by the securities in which the residuary estate is invested and delivered it, together with the securities, to the trustees, the trustees must in the absence of provisions in the will indicating that the testator had a different intention treat such sum so delivered to them as income and distribute it in accordance with the terms of the will. *Wilcox v. Wilcox*, 26 Haw. 219, at page 229.

The latest expression of the Supreme Court of the Territory of Hawaii, the Court of last resort in the

Territory, is the recent case of *Hawaiian Trust Company, Limited, Trustee, v. Cohen*, 35 Haw. 795. In that case there was involved a will in which all of the residue was left in trust to pay the net income to the decedent's widow. A large part of the assets of the estate were mortgaged or pledged and numerous claims were filed against the estate. The proceeds of the personal property were insufficient to pay the debts and the executor took possession of the mortgaged real property, collected the rents and paid taxes, interest and other charges thereon. In June of 1938 the executor had accumulated sufficient income to meet the amount of the mortgage obligations that the mortgagees were willing to accept. He petitioned the Court for permission to distribute and convey the real estate subject to the mortgage. The widow claimed that she was entitled to all the net income accruing after the date of the testator's death and, therefore, that she was to be reimbursed for all the income disposed of by the executor and also that applied in reduction of the principal of the mortgage. She contended that under the rule of *Wilcox v. Wilcox, supra*, she was entitled to the income of the estate from the date of death of the testator. The Court said it is well established in this jurisdiction that when the testator gives the residue to the trustee to pay the income thereof to a named person for life and no time is mentioned in the will for the commencement thereof, the beneficiary is entitled to the clear residue as afterwards determined, to be computed from the time of the date of death. The Court further stated that, although there are some decisions to the contrary its holding

is supported by the great weight of authority, and the reason is that the life tenant is first in the consideration of the testator.

Section 1, *Revised Laws of Hawaii 1935*, reads in part as follows:

“*Sec. 1. Common law applies except when.* The common law of England, as ascertained by English and American decisions, is declared to be the common law of the Territory of Hawaii in all cases, except as otherwise expressly provided by the Constitution or laws of the United States, or by the laws of the Territory, or fixed by Hawaiian judicial precedent, or established by Hawaiian usage; * * *.”

An examination of the authorities makes it clear that the rule set forth in the cases of *Hawaiian Trust Company, Limited, v. Cohen, supra*, and *Wilcox v. Wilcox, supra*, is in accordance with “the common law of England as ascertained by English and American decisions”, which is declared to be the common law of the Territory of Hawaii.

In *Pollock v. Learned*, 102 Mass. 49, it was said that it has long been held in England that in cases of bequests of life estates in a residuary fund, when no time is specified for the commencement of the interest or the enjoyment or use of the income, the legatee for life is entitled to the income of the clear residue as afterwards ascertained, to be computed from the time of death, and that the same rule was made a part of the positive law of the State of Massachusetts as early as 1848 and is also the law of New York.

In *Ayer v. Ayer*, 128 Mass. 575, it was said that the general rule of law is well established that a tenant for life is entitled to the income of a fund set apart for his benefit from the date of death, and that the general rule of law is in harmony with the Massachusetts statute to the effect that when by a will an annuity income or interest of property or a fund in trust is given, the beneficiary is entitled to receive the same from and after the date of death of the testator.

In *Sargent v. Sargent*, 103 Mass. 297, the Court again said that the general rule is established that the life tenant is entitled to the income of the residuary given in trust from the time of the testator's death, and that any other rule would take the income from the life tenant and apply it to increase the capital for the benefit of the remaindermen. To the same effect is *Edwards v. Edwards*, 183 Mass. 581, 67 N. E. 658.

In *Lawrence v. Littlefield*, 215 N. Y. 561, 109 N. E. 611, the Court had for consideration a Massachusetts statute to the effect that when an annuity or income of property, real or personal, is given by will in trust for the benefit of a person for life, such person shall be entitled to receive and enjoy the same from and after the decease of the testator unless otherwise provided in the will or testament. The Court said that an examination of the *Edwards*, *Sargent* and *Ayer* decisions, *supra*, discloses that the rule there set forth is not based on any statute but was the rule of law with which it was said that the statute above referred to was in harmony. The Court cited *Williamson v.*

Williamson, 6 Paige, Ch. 298, 304, which involved the question of the date from which interest was to be paid to the widow on a bequest to her of the use of the residuary estate during her life, and where it was concluded that the life tenant of the residuary estate, where no time for the commencement of interest or enjoyment of the use or income is fixed, is entitled to the interest or income of the clear residue as afterwards ascertained from the date of death. The Court quoted from that case as follows:

“All the cases which appear to conflict with this rule * * * will be found to be cases in which the testator had directed one species of property to be converted into another, or the residuary fund to be invested in a particular manner, and had then given a life estate in the fund as thus converted and invested. In such cases it appears to be consistent with the will of the testator to consider the life estate as commencing when the conversion takes place, * * * either within the year or at the expiration of that time. But, as a year is considered a reasonable time for the executor to comply with the testator’s directions as to conversion * * * the legatee cannot be kept out of the interest or income beyond that period.”

In *In re Stanfield’s Estate*, 135 N. Y. 292, 31 N. E. 1013, it was said that where the income of an estate or a designated portion is given to a legatee for life, he immediately becomes entitled to it whenever it accrues, and if it produces income from the death of the testator he can require the executor to account to him for the income from that time. The rule that the

general legacy shall not bear interest until the expiration of one year from the grant of letters has no application in such case. It is by its terms limited to general legacies payable out of corpus of the estate. Here the gift is of nothing possessed by the testator in his lifetime but of that which is to arise or accrue afterwards. The weight of authority undoubtedly now is in favor of allowing the payment of annuities or income to commence at the testator's death, and the authority seems abundant that when a sum is left in trust with a direction that interest and income are to be applied to the use of a person he is entitled to the interest from the date of death.

The Commissioner states that the cases involving the law of Hawaii support his contention to the effect that the accumulated income of the estate was turned over to the residuary trustee and not as income to which the beneficiaries of the trust were entitled, and cites in support of that contention (Br. 10) *Hawaiian Trust Company v. Von Holt*, 216 U. S. 367, which he contends involved a will with substantially the same effect as in the instant case. In that case the Court had before it a bill in equity by the trustees for instructions. The executors had turned over to the trustees all the property held by them on their discharge. The question involved was whether the widow was entitled to any part of the income of the estate derived from real property before it was turned over to the trustees. The executors under the will were ordered to reduce all the estate, real and personal, to possession and to collect the income pend-

ing distribution, to have its value adjudged, to pay the debts and funeral expenses. The widow was given one-third of the value of the personal property as adjudged after the payment of debts, which was to be paid to her in cash. If the position of the estate did not warrant the payment in full, it was to be paid to her as soon as the interest and income of the estate permitted, without selling the real estate or sacrificing the personal property to raise the sum, providing that the payment must be made in two years and that no interest was to be paid during that two year period. The widow was also to have the use and occupancy of decedent's dwelling house, furniture, etc., and such allowance as the Court might fix. As soon as the debts were paid and the widow's right to one-third of the personal estate was satisfied, the executors were to conclude the administration and distribute the residue to the trustees. The trustees were to reduce all property to possession and manage it and segregate the accounts of the real and personal property, and out of the income of the real estate to pay one-third thereof to the widow during her life. The provisions of the will were stated to be in lieu of dower and the widow was one of the executors and trustees. It took five years to administer the estate, although it was ready for distribution more than three years prior to the actual closing of administration. The Court held that since the trustees were required to segregate the accounts of the real estate after it was distributed to them, the will actually meant that one-third of the income of the real estate was not given to

the widow but only one-third of the income of the real estate after it came into the hands of the trustees, and, therefore, under the provisions of the will it was not until the real estate was actually in the hands of the trustees that they began to pay income to her. The Court distinguished the provisions of the will from that in *Lovering v. Minot*, 9 Cush. (Mass.) 151, where one-third of the income of the real estate generally was given to the beneficiaries. The Court there held that the beneficiaries were entitled to income from the death and that when the funds were transferred from the executor to the trustee the accounts of the executor must show what was received from income and what from capital and it was the duty of the trustee to distribute the part which was composed of income and retain the capital.

The *Von Holt* case, *supra*, clearly falls within the class of cases discussed in *Lawrence v. Littlefield*, *supra*, where the Court said that all the cases which appear to conflict with the rule that the life tenant of the residuary estate is entitled to the use or income from the date of death, will be found to be cases where the testator directed one species of property to be converted into another, or a residuary fund to be invested in a particular matter, and then the life estate to be in the fund so converted and invested.

In the case of *Wilcox v. Wilcox*, *supra*, the Supreme Court of the Territory of Hawaii expressly stated that the facts in the *Von Holt* case (designated *Campbell Estate v. Campbell-Parker*, 18 Haw. 34, in the Supreme Court of the Territory of Hawaii) was

not inconsistent in any respect with the holding in the *Wilcox* case, and then pointed out that the provisions in the will of James Campbell differ in material respects from the provisions of the will in the *Wilcox* case. In the Campbell will the Supreme Court pointed out (p. 230) the testator directed that after the payment of his debts, etc., and the aforesaid provision for his wife (payment to her of such amount as the probate judge shall approve for the maintenance of herself and children), his executors should obtain a decree of distribution of his estate. He then devised and bequeathed to the trustees named in the will all the rest, residue and remainder of his estate not otherwise given in trust, and provided that "and the trustees herein provided for, from and after their entry upon their functions of trust hereunder shall make such further provision for the maintenance of said children as is hereinafter directed". The will then continues:

"With respect to all property which shall be so distributed to them, I direct my trustees aforesaid to reduce it to possession and to collect all the rents, issues, profits, income and revenue thereof, to invest all moneys that shall come to their hands by virtue hereof and which are not otherwise herein specifically bequeathed, assigned or appropriated."

The Court held that in that case the will provided that it was only after the administration was closed and the estate distributed to the trustees that either the widow or any of the children were to begin to share

in the income of the real estate. The will clearly provided for the creation of a trust out of the residue of the estate and for the payment of the income of the trust, which the testator directed to be made by the trustees, from and after their entry upon their functions of trust. That is an all together different arrangement from that in the present case, where payments were to be made by the executor from the date of death and the trustee was to continue those payments without interruption, and where the scheme of the testator necessarily involved the carrying over of the income of the estate as income in the hands of the trustee. It is apparent from a reading of the *Wilcox* case that the rule stated there governs in the present case, and when the more recent case of *Hawaiian Trust Company, Limited v. Cohen* is considered, there is no doubt but that the law of Hawaii is that in cases such as the present one the income of the estate retains its character as such upon distribution to the residuary trustee.

- (B) Under the provisions of the will the income of the estate retained its character as income when distributed to the testamentary trustee.

The petitioner on review argues (Br. p. 6) that under the terms of the will the income accumulated during the period of administration of the estate became part of the corpus of the estate and that the testamentary trustee took it over as such in January, 1936. The petitioner on review states the facts supporting his argument as follows:

The will provided that certain payments be made during the period of administration and after certain specific bequests the rest, residue and remainder was devised and bequeathed to the testamentary trustee; the petition of the executor to the Probate Court requested an order to deliver over such property as remains, and pursuant to this request the Probate Court ordered the executor to transfer the assets remaining in its hands; the petition before the Board stated that the amount herein involved was included in the residuary estate of the taxpayer and the Board stated that the \$20,504.58 cash was included in the residuary estate of the decedent; the trustee was to control, manage and hold the trust estate and collect the income therefrom and he could reinvest unapplied income; the payments were to be made from the accumulations and net income of the trust; there was a difference between the payments to the widow and the children during the period of administration and those to be made under the trust, in that during the administration period payments were to be made without regard to the presence or absence of income; the beneficiaries were to receive certain amounts and there was no requirement that such amounts be paid from the income of the estate, nor did they have claim to the income as such; since the will made no disposition of the income of the estate it became part of the corpus, that is, an indivisible part of the whole sum which was to pass as such to the residuary trustee, thereby becoming the trust corpus from which income was to be derived to make certain payments to

the beneficiaries of the trust; the payments from the trust were to be made from the accumulations and net income of the trust and payments during administration were to be made from any source, while those from the trust were to be made only out of income made or accumulated during the existence of the trust; the beneficiaries of the trust had no claim to the amount herein involved as income even after it reached the trust, since their claim was to be paid as income from the net income of the trust; the decedent intended the income received during the period of administration to pass under the residuary clause and not as income which the legatee could demand; the parties so considered the accumulated income and it has not been paid to the beneficiaries as income but was turned over as part of the residuary estate, out of which the income might be payable but not as income to which the beneficiaries of the trust were entitled.

The statements of the facts on which the petitioner on review bases his argument contain a number of misstatements of fact as well as misconceptions of law. Actually the petition before the Board stated that:

“Included in the residuary estate of the taxpayer which was conveyed, transferred and delivered on January 22, 1936, to Bishop Trust Company, Limited, Trustee and sole residuary legatee under the will and of the estate of John A. McCandless, Deceased, pursuant to an order of court made January 21, 1936, was \$20,504.58 of the \$31,248.09 cash income received by the tax-

payer during the taxable year ended January 31, 1936.” (Pet. V(M), R. 8.)”

The Commissioner’s answer was as follows:

“* * * V * * * (M) Admits that included in the residuary estate of the taxpayer that was conveyed, transferred and delivered on January 22, 1936, to Bishop Trust Company, Limited, Trustee under the will and of the estate of John A. McCandless, Deceased, pursuant to an order of court made January 21, 1936, was \$20,504.58 cash income received by taxpayer during the taxable year ended January 31, 1936, as alleged in subparagraph (M) of paragraph V of the Petition, but denies the remaining allegations contained in said paragraph.”

Although the petition of the executor to the Probate Court requested an order to deliver over such property as remains, the petition also asked for the approval of its accounts as shown on schedules attached to the petition, which schedules showed that all the cash on hand at the time was accumulated income for the period, and the Court specifically approved the said schedules. The respondent on review did not offer the said schedules or the petition in evidence because the Commissioner in his answer to the petition admitted that the \$20,504.58 turned over to the residuary trustee was income of the estate for the taxable year.

Another fact which bears on the problem is that the executor was also given authority to keep the administration of the estate open for such length of time

as may seem necessary to it to best protect the interests of the estate, and the executor was authorized to pay legacy, inheritance, transfer or other duties or taxes on the estate or any interest in the estate from income and/or capital as seems to the executor to the best interest of the estate. It was also given power to sell or lease real estate if it was deemed advisable before the personal property of the estate was sold. It was also given authority to borrow money on the security of the assets of the estate in order to secure funds to pay taxes or charges or to finance the estate, or for any other reason that seems necessary or advisable to the executor. If money was borrowed the executor was authorized to repay it from income and/or capital and it was directed that the specific bequests be paid as soon as possible without embarrassment to the estate but without drawing interest. While it is true that the payments by the trustee were to be made from the accumulation and net income of the trust, the first payment was to be made one month after the last monthly payment by the executor, and the trustee was given discretion to pay larger amounts out of the income to meet an emergency of any kind affecting the welfare of the widow or of all or any of the decedent's grandchildren and for their further education, which payment was to be treated as an expense of the estate and was not to be a charge on the interest of the beneficiary.

The statements that the beneficiaries did not have any claim to the income of the estate as such and that since the will made no disposition of the income of the

estate it became part of the corpus of the estate and that the payments from the trust were limited to the accumulations and net income of the trust estate itself are all contrary to the law of Hawaii as hereinbefore discussed.

The decedent clearly intended the income received during the period of administration to pass as income to the legatees. This is evidenced by the fact that the decedent, who is presumed to know the law of the Territory, expressly provided that no interest should be paid on specific bequests, but he made no such denial with regard to the persons taking the income of the residue. In view of the provisions of the will permitting the executor to extend the period of administration as long as it deemed necessary, a denial of the right to income in the hands of the beneficiaries of the trust would be necessary in order to cut them out of their right to receive the same, and this the decedent was presumed to know.

The statement that the parties considered the accumulated income as a part of the residuary estate and that it has not been paid out to the beneficiaries as income is not supported by any evidence. There is no evidence that it was not considered income and no evidence that it was not paid to the beneficiaries as income. The schedules attached to the petitions of the executor showed it as income and under the law of the Territory it is required to be kept separate. Respondent's Exhibit "A" (R. 93-94) contains the receipts and disbursements of the petitioner for the taxable year as shown on the books of account of the executor.


The testimony with regard to the same of Mr. Ernest R. Cameron (R. 46) stated that this document taken from the books of the petitioner showed the \$20,504.58 to be the balance of income realized by the taxpayer in the taxable year which was on hand at the time of the final distribution.

The case of *Burnet v. Whitehouse*, 283 U. S. 148, cited by petitioner on review (Br. 8) is not in point. That relates only to annuities. The payments to the widow and grandchildren are not here in question. The issue here involved concerns only the distribution by the executor to the testamentary trustee. Nor is the case of *Spreckels v. Comm.*, 101 F. (2d) 721, or the case of *Lynchburg Trust & Savings Bank v. Comm.*, 68 F. (2d) 356 (cited Br. 9) in point.

In the *Spreckels* case the income of a testamentary trust was to be accumulated and paid to the beneficiaries as each reached his majority. The question dealt with income which was to be accumulated for future distribution and was governed by Section 162(b) of the Internal Revenue Act, whereas the present case deals with income of estates in administration paid out during administration and is governed by Section 162(c) of the Internal Revenue Act.

In the *Lynchburg* case it was held that where under a will the income of the residuary trust is to be paid out and there is discretion in the trustee to withhold it, and where the amounts withheld were deposited in separate accounts for the account of the beneficiaries, the amounts paid by the trustee into such funds were

properly paid or credited and were deductible by the trustee. We do not see any application of that case to the present case.

 In the case of *County National Bank and Trust Company v. Helvering*, 122 F. (2d) 29 (C.A. D.C.) (cited Br. 9) there was no testamentary trust involved. All the residuary estate was directly distributable to the beneficiary without the intervention of a trust. There the Commissioner attempted to tax the beneficiary for income of the estate which he claimed was distributed to him in an amount in excess of the amount actually distributed to him. The normal income of the estate had been reduced by a capital loss and the actual net income was distributed to the beneficiary. The Commissioner disallowed the capital loss as an item affecting the corpus of the estate, thereby increasing the taxable net income of the estate, all of which he attempted to tax to the beneficiary. It was held, however, that since the beneficiary only received the net income of the estate and not the taxable net income as determined by the Commissioner, he was not taxable on any amount in excess of that received by him. Again, we do not see how that case is applicable to the present case.

In the case of *Buckner v. Comm.*, 45 B. T. A. No. 90, cited by petitioner on review (Br. 10), the Commissioner claimed that the trust was a member of a partnership and that the beneficiary was taxable for her distributive share of the profits of the partnership. The Board held sustaining the taxpayer's contentions

that no distribution had been made by the estate to the trust and that the estate was the member of the partnership, and that, therefore, under Section 162(c) the beneficiary could only be taxed on what was received by her from the executor and that the amount so paid to her was deductible by the estate.

There is nothing in the will which indicates any intent on the part of the testator other than that the income should be paid to the beneficiaries beginning at the date of death, in accordance with the law of the Territory. The will of John A. McCandless provides for payments by the executor of \$1000 per month to his wife and of \$250 per month to each of four named grandchildren during the administration of the estate and until such time as the residuary estate has been distributed to the trustee. The residue and remainder of the estate after certain specific bequests was given to the trustee, who was directed to pay and deliver from the accumulations and net income of the trust estate \$1000 per month to the widow and \$250 per month to each of the four named grandchildren, the first of such payments to be made one month after the last monthly payment made by the executor. The will further provided that in the event of any emergency arising, whether from illness, necessity for special or surgical care or any other emergency of any kind or sort which the trustee in its sole discretion may consider vitally affecting the welfare of the wife or all or any of testator's grandchildren, or if the trustee shall decide that it is necessary or useful to provide for

further education for any or all of said grandchildren, then and in any such event and as often as the same shall occur the trustee is authorized to pay out of the accumulations and income of the trust estate a larger share than the monthly payments therein provided.

It is thus seen that not only is there nothing in the will which indicates any intention that the decedent intended the income of the residuary estate during the period of administration to be anything but income in the hands of the trustee, but the will itself contains a plan which requires that the income during the period of administration be segregated and keep its character as income, because it is only out of such income and the accumulations of income that the trustee can make the required monthly payments to the named beneficiaries as well as any emergency payments that it may think necessary. All such payments are required to be made from income and accumulations thereof and the first payment is required to be made one month after the last payment by the executor. The amount of income and the accumulations thereof constitute the limit of permissible payments to beneficiaries and it is necessary, therefore, to segregate income in the hands of the trustee. Accordingly, where the will, as here, clearly shows a purpose and necessity for segregating income during the period of administration, it would be all the more true that under the law of the Territory of Hawaii, as set forth *supra*, such income of the estate in administration retains its character as income and remains income in the hands of the trustee.

It should be noted that the scheme of the will, as set forth in paragraphs second, third and eighth (e) and (f), is that payments begin from the time of death and are payable one month after the death. Upon the transfer of the residuary estate to the trustee, the trustee continues to make the payments beginning one month after the last payment by the executor. The will provides a unified scheme whereby income is paid monthly from the time of death, first by the executor and then by the trustee in equal monthly payments until the termination of the trust, without interruption by reason of the close of administration of the estate. The testator has in effect expressed the very intention applied under the rule, namely, that income from the time of his death shall be distributed, and in addition the scheme which he has set forth in his will makes it imperative that the income of the estate during administration be treated as income of the trust. Assume, for example, that the executor made its monthly payments to beneficiaries on the 30th of each month. Assume, as in the present case, that it made its final distribution to the trustee on the 26th of the month. The next payment from income which the trustee would be required to make to beneficiaries would be due on the 30th. It is quite apparent that unless the income of the estate retained its character as income in the hands of the trustee, the trustee might be unable to make the payment required to be made on the 30th of the month and the intention of the testator to make continuous monthly payments without interruption would be thwarted.

The scheme set out in the will in the *Wilcox* case, *supra*, is exactly the same as the scheme set out in the will of John A. McCandless, namely, fixed payments to named beneficiaries payable during administration by the executor and thereafter payable by the trustee out of the income.

It is, therefore, respectfully submitted that the income of the estate in administration upon distribution to the residuary trustee retained its character as income in its hands.

CONCLUSION.

It is therefore respectfully submitted that:

1. It is not necessary that the payment of the income of an estate in administration be made to a legatee, heir or beneficiary as income in order that such income paid may be deducted by the estate in computing its net income.

2. Even if it were necessary that income of an estate in administration be paid to a legatee, heir or beneficiary as income in order to be deductible by the estate in computing its net income, the income here in question was so paid out to the beneficiary as income.

(A) Under the laws of the Territory of Hawaii the income in question retained its character as income upon distribution by the executor of the estate.

(B) Under the provisions of the will the income of the estate retained its character as income when distributed to the testamentary trustee.

Wherefore, respondent on review prays that the decision of the Board of Tax Appeals be affirmed.

Dated, Honolulu, T. H.,

February 13, 1942.

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